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EDITOR'S NOTE: *This article is adapted from a speech given by DH&S partner Steven J. Golub at the 1981 Financial Outlook Conference sponsored by The Conference Board and held in New York City this past February. Steve was a manager with the New York office when, in June 1977, he was named to a two-year term as a Professional Accounting Fellow in the Office of the Chief Accountant of the Securities and Exchange Commission. In February 1979, Steve was appointed Deputy Chief Accountant of the SEC, a position he held until rejoining DH&S. He was admitted to the firm in June 1980. Presently with the Research Department in Executive Office, Steve is a member of the FASB's Measurement Task Force.*

We are all familiar with the expression that only two things are certain in life—death and taxes. I am sure that all of us hope that double-digit inflation and high interest rates do not become permanent additions to that list. However, as we enter the 1980s, inflation, interest rates and federal spending are dangerously high, and forecasters are predicting a continuing sluggish economy. The Council of Economic Advisers has released a forecast for 1981 of less than 1 percent economic growth and an inflation rate of 11 percent.

While the answers to halting the inflationary spiral do not lie in presenting inflation-adjusted data, we should recognize that such data can and should be used by our nation's policymakers in addressing the seeds of the problems that beset our economy today. Unfortunately, considering the current state of our economy, it is difficult to argue with the notion that the time has come for presenting inflation-adjusted data in financial reports.

I would like to present here some observations on the evolution of Statement of Financial Accounting Standards No. 33, *Financial Reporting and Changing Prices*; a discussion of some of the key aspects of the statement and our experience with it to date; suggestions as to how inflation-adjusted data should be used by company managements, investors and our nation's policymakers; and, finally, some personal thoughts concerning future trends in financial reporting.

Evolution of Statement No. 33

The rise in the inflation rate from the 4-percent level in the early 1970s to the 12-percent level in 1974 brought renewed interest to the inflation-accounting issue. While the Financial Accounting Standards Board was studying a general purchasing-power approach, the Securities and Exchange Commission took the lead in 1976 by adopting its controversial replacement cost rule.

The principal reasons cited by the SEC for adopting its replacement cost rule were that historical-cost-based data do not adequately reflect current business economics and, in an inflationary economy, specific costs and prices change at different rates than does the general price level. While replacement cost information did not gain wide acceptance in the business community, over time some analysts began to use the data. However, many changes were needed to make the data more meaningful, and the SEC and others encouraged the FASB to continue to study the issue.

As we all are aware, this led to the adoption by the FASB of Statement No. 33 in 1979 and the concurrent rescission of the SEC's replacement cost rule. This was a desirable step because it returned the initiative in this area to the private sector where further developments could draw on conclusions reached by the FASB in its conceptual framework project. The adoption of this statement has a far-reaching impact, for it represents the first time that a private-sector standard-setting body established a standard for reporting financial information outside—but accompanying—the basic financial statements. It recognizes, through an experimental approach, that historical-cost-based financial statements alone are not providing sufficient relevant financial information in an inflationary environment, and thus it supports the evolutionary development of supplemental disclosures.

Statement No. 33 adopted two fundamentally different approaches to reporting the effects of changing prices—historical-cost/constant-dollar accounting for the effects of general inflation and current-cost accounting for the effects of changing prices of specific goods and services. I do not intend to debate the merits of either of these approaches. Rather I would like to assess our experience to date with inflation-adjusted data.

Experience With Inflation Data

The FASB anticipates that, over time, experience with the information called for by Statement No. 33 will help it to assess which combination of information—historical cost, current cost, fair value, or some other—best achieves the objectives of financial reporting. Further, such experience has implications for the ultimate outcome of the FASB's conceptual framework project.

As an initial step in 1980, the FASB staff with the aid of its Measurement Task Force issued a booklet entitled *Examples of the Use of FASB Statement No. 33, Financial Reporting and Changing Prices* that follows the general approach of *Accounting Trends and Techniques* to show how some companies reported inflation data in their 1979 annual reports. The booklet presents examples of four principal topics: management's analysis and interpretation of the changing-prices information, constant-dollar and current-cost measures; other disclosures required by Statement No. 33; and formats for displaying the information. Admittedly with some bias since I am a member of the Measurement Task Force, I believe nonetheless that the booklet provides some useful guidance for presenting meaningful inflation-adjusted data.

In addition to this booklet, several other surveys of 1979 inflation data have been conducted. The results of these surveys indicate that inflation-adjusted income is approximately 60 percent of historical income and that inflation-adjusted income tax rates are approximately 30 percent above statutory rates. Many companies addressed this latter point in their 1979 annual reports by disclosing their inflation-adjusted income tax rates, even though such information is not required under Statement No. 33.

Three additional points are noteworthy in a review of 1979 annual reports. First, those companies that made a meaningful attempt to analyze and interpret the data called for by Statement No. 33 provided significant narrative discussion of the information. This trend must grow if experimentation with inflation-adjusted data is to be successful. Second, little information beyond that required by the statement was presented. Third, and possibly most important, little evidence exists to date to indicate that analysts or others are using the inflation data in their decision-making process. Let me expand upon this last point for a moment.

There are only a few companies that have indicated that they are using some form of inflation-adjusted data in their internal decision making. While I would agree that it is more meaningful to analyze inflation-adjusted data for a period of years rather than only one year, it is a bit troubling to see the lack of use of the Statement No. 33 data during this past year. I hope that as we gain more experience and users become more comfortable with the data, their use will become more widespread.

In that regard, the FASB staff is developing a five-year research plan for reviewing, analyzing and interpreting the Statement No. 33 data. The FASB Measurement Task Force has under consideration an initial formulation of a research plan being developed by the FASB staff. This fundamental research should play a significant role in gaining more understanding of the data, how they are used, what they indicate, and how they should fit into the ultimate conceptual framework model.

Current-Cost Measures

Since current-cost data were required for the first time in 1980 annual reports, let me now briefly discuss the various measures that those companies electing to present current-cost data in their 1979 annual reports used in developing such information. Current-cost techniques employed include direct pricing, external and internal indices, unit pricing, specific identification, appraisals, and the LIFO method of inventory valuation.

Companies generally used different current-cost measures for different types of assets. For example, Ogden Corporation used various indexes published by government and private organizations applied to the historical cost of the assets for acquired property, plant and equipment; engineering estimates and current prices for company-constructed property, plant and equipment; naval engineers' and ship brokers' estimates for vessels; appraisals and the CPI applied to historical cost for land; and direct pricing for raw materials. Depreciation expense was based on the average current cost of properties, with no change in methods and assumptions from those applied in the historical-cost financial statements. Cost of goods sold was based on either current cost at the time of sale of material, labor and overhead, taking into account the inventory turnover rates for these components, or the LIFO inventory-valuation method.

The FASB booklet discusses the Ogden example as well as others. It serves to illustrate the flexibility that exists in Statement No. 33 for presenting current-cost information—a flexibility that preparers should utilize in developing the information most relevant in their particular circumstances.

How Inflation-Adjusted Data Should Be Used

After surveying these varied techniques for developing current-cost data, and considering the associated cost, one might appropriately ask, "What purpose does the presentation of this information serve?" It is an important question, and yet the answer rests to a large extent with preparers.

In my view, the real benefit of inflation-adjusted data is in providing decision makers—company managements, investors and our nation's policymakers—with more relevant information in an inflationary environment. These data can be used by company managements in making more-informed capital-expenditure and dividend-policy decisions, by investors in making more-informed investment decisions, and by our nation's policymakers in developing more-informed capital-formation and tax-policy decisions.

At the company level, let me focus on the disclosures made by General Electric in its 1979 shareholder report. Management's main theme in this report is that "inflation increasingly widens the gap between industry's reported and real profits—drastically weakening U.S. business investments in keeping competitive." Management is extremely supportive of the FASB initiative, noting that these inflation-adjusted supplementary data "will show how inflation escalates reported sales and earnings, causes shortfalls in depreciation provisions, and boosts effective tax rates to counterproductive levels." Management goes on in the report to describe how it is experimenting with inflation-adjusted data in its capital-budgeting process:

> Since 1973, your Company has been experimenting with various techniques to measure the impact of inflation, to incorporate the perspectives provided by such measurements into decision-making, and to stimulate awareness by all levels of management of the need to develop constructive business strategies to deal with inflation. The objective is to ensure that investments needed for new business growth, productivity improvements and capacity expansions earn appropriate real rates of return commensurate with the risks involved.

How does this micro approach translate into national policy? The answer to this question lies in the aggregation of the data generated by the FASB initiative that may very well indicate the need for restructuring federal tax policy so as to mitigate the impact of inflation on capital formation. Our nation's policymakers need to be provided with hard data on the inflation-adjusted effective income-tax rates of companies, not only the rates reported in historical-cost financial statements. The surveys I discussed earlier should provide the type of evidence necessary to make this point clear.

Another way to get attention centered on inflation accounting is through the financial press. One of the more incisive articles I have read on the subject is in the February 2, 1981 issue of *Forbes*. The article refers to a cash-flow study performed by Kidder, Peabody & Co. The study develops two inflation-adjusted amounts—distributable cash flow and discretionary cash flow—for certain companies that make up the Dow Jones Industrial Average. Distributable cash flow is defined as reported income after adjusting depreciation for inflation—that is, deducting the amount necessary to maintain property, plant and equipment. Discretionary cash flow then subtracts cash dividends from that amount. The study indicates that, for nineteen companies out of the thirty in the Dow Jones, aggregate reported net income for the period 1975 to 1980 was approximately $47 billion, whereas distributable cash flow was almost zero. Further, discretionary cash flow was a negative $25 billion. While the methodology used in the study may be somewhat controversial and the actual results overstated, the direction of its results is clear. Certain American businesses have begun to liquidate themselves. We all must step up to this reality in the 1980s if we are to reverse the trend of the 1970s.

How can preparers help to get the message home to our nation's policymakers? I believe the approach taken in presenting inflation-adjusted information in annual reports is an important starting point. In that regard, we can all take a lesson from General Electric's presentation in its 1979 annual report.

Future Trends in Financial Reporting

In closing, I would like to focus on an area in financial reporting that I believe will receive significant attention in the 1980s—cash flow. In my opinion, the existing statement of changes in financial position is not as useful as a statement of cash flow could be in an inflationary environment. The reasons for this become clearer if one focuses on the distributable and discretionary cash-flow information mentioned earlier. Current historical-cost-based financial statements alone simply do not present cash-flow information in the most meaningful way.

The relevance of cash-flow information was highlighted in a recent FASB study in which executives, analysts and academics indicated that 67 percent thought cash-flow information was "highly important"—while only 49 percent thought the same of earnings-per-share data. Former SEC Chairman Harold Williams was recently quoted as saying, "If I had to make a forced choice between having earnings information and having cash-flow information, today I would take the cash-flow information." While I agree with Mr. Williams, both sets of information—cash flow and earnings—are in fact relevant. Both need to be analyzed and interpreted over a period of years to be most meaningful. The question that remains is how the FASB's conceptual framework will be developed to fill this need.

The framework must continue to emphasize the needs of users—including managements, investors, analysts and our nation's policymakers. As the framework develops, this will result in some trade-offs between the relevance and the reliability of the data displayed in the model. I believe that supplemental disclosures—similar to those presented for the effects of changing prices—provide an appropriate means of dealing with this trade-off, that is, more relevant, less reliable information can be presented as supplemental disclosures to historical-cost financial statements.

Further, I believe that within the reporting earnings and funds flows phases of the conceptual framework project we will see the development of more disaggregated earnings information with less emphasis on earnings per share and more emphasis on the key components of operating performance and cash flow.

All of us—as managers, businessmen, accountants and investors—are focusing more and more on cash flow. We must be more cognizant of a company's liquidity in an inflationary environment. I would like to close with a quote emphasizing the importance of cash-flow information that was included in the *Forbes* article referred to earlier:

> *Though my bottom line is black, I am flat upon my back,*
> *My cash flows out and customers pay slow.*
> *The growth of my receivables is almost unbelievable;*
> *The result is certain—unremitting woe!*
> *And I hear the banker utter an ominous low mutter,*
> *Watch cash flow*